

Internal Revenue Service

memorandum

CC:TL-N-2330-89

Br2:LSMannix

date: MAR 22 1989

to: Regional Counsel, Southeast
Attn: [REDACTED]
Special Trial Attorney

CC:SE

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This responds to your request for tax litigation advice established January 4, 1989. The Tax Court in the instant case granted a continuance and no trial date has been set.

ISSUES

1. In applying the I.R.C. § 501(c)(12) 85% test, does the code require a literal sourcing of income? If income cannot be directly traced to an [REDACTED] member, does that income automatically become part of the 15% limitation?

2. After determining the amount of income traceable to members, should there be "an above the line" adjustment to this income for any refunds made or credited to members for whatever reasons? The most common refund is for patronage dividends.

3. If a simplistic and literal tracing of income is inapplicable for various reasons, the most important income allocations are the following:

- a. Capacity payments paid by [REDACTED].
- b. Energy payments paid by [REDACTED].
- c. Operating expense payments paid by [REDACTED].
- d. Initial payments made by [REDACTED], [REDACTED], [REDACTED] and [REDACTED] under Safe Harbor leases.
- e. Annual interest payments made by [REDACTED], [REDACTED], [REDACTED] and [REDACTED], pursuant to the Safe Harbor leases.
- f. Parity payments made by [REDACTED] and [REDACTED] for use of commonly utilized facilities owned by [REDACTED].

How should these income items be allocated?

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4. This office received an undated memorandum from Director, Employee Plans and Exempt Organizations Division to Director, Criminal Tax Division on February 18, 1987. Do you agree with the positions set forth in this memorandum?

5. Is [REDACTED] subject to the same taxable year guidelines for deduction of patronage dividends provided under Subchapter T, section 1382(d), even though the activities of [REDACTED] are not governed by Subchapter T?

6. Is the term "payment" as used for Subchapter T Cooperatives the same as "allocated" for cooperatives not covered by "Subchapter T?"

7. If [REDACTED]'s net income is increased after the filing of its return due to an Internal Revenue Service examination, can [REDACTED] charge any finally determined increase to its income to deductible patronage dividends?

8. Depending on the scope of the "payment/allocation tests to be applied to [REDACTED]'s income," how can [REDACTED] effectuate and substantiate a deduction for patronage dividends? Which one (or more) of the following, if any, will qualify a deficiency amount as deductible patronage dividends:

- a. Statement in the By-Laws that the organization will be operated on a cooperative basis.
- b. Statement in the By-Laws that amounts received in excess of operating costs and expenses is to be credited to one or more capital accounts.
- c. Passage of a resolution by the board of directors that all income is to be credited to patrons in one or more capital accounts.
- d. Passage of a resolution by the board of directors that a specific sum has been allocated as patronage dividends and/or credited to capital accounts.
- e. Allocation of an amount on the books of the cooperative as patronage dividends and crediting it to capital accounts prior to year-end without patrons being notified of specific amounts allocated to them.
- f. Allocation of an amount on the books of the cooperative as patronage dividends and crediting it to capital accounts after the year-end, but before

the due date of the return without patrons being notified of specific amounts allocated to them.

- g. Allocation of an amount on the books of the cooperative as patronage dividends and crediting it to capital accounts after the year-end and after the due date and/or filing date of the return without the patron being notified of specific amounts allocated to them.
- h. Allocation of an amount on the books of the cooperative as patronage dividends and crediting it to capital accounts prior to year end with patrons being notified of specific amounts credited to them.
- i. Allocation of an amount on the books of the cooperative as patronage dividends and crediting it to capital accounts after the year end, but before the due date of the return with patrons being notified of specific amounts allocated to them.
- j. Allocation of an amount on the books of the cooperative as patronage dividends and crediting it to capital accounts after the year end and after the due date or filing date of the return with patrons being notified of specific amounts allocated to them.

9. If patrons are required to be notified of specific amounts allocated to them as patronage dividends, what information must be furnished to the patron?

10. Are the sources of income listed in Issue 3 patronage sourced income which may be classified as deductible patronage dividends or are the sources income listed in Issue 3 of nonmember income which must be included in taxable income with no deduction for patronage dividends?

11. What tests are to be applied in making income allocations?

12. Is the same test that is applicable to income allocations to be used in expense allocations?

13. After applying these tests to various expenses of [REDACTED], what is the proper characterization/allocation of the following major items:

- a. Rental expenses related to Safe Harbor leases?
- b. Interest payments made by [REDACTED] on [REDACTED] indebtedness?

- c. Depreciation on Plant [REDACTED] - first assuming the Safe Harbor leases are approved; and second, assuming that the Safe Harbor leases are disapproved.

If depreciation is allocated to member use, is it proper to use ACRS since during the first [REDACTED] years of the operation of Plant [REDACTED], the power is not being directly used by members?

- d. ITC.

- e. Can expenses attributable to Safe Harbor leases be adjusted in amount to reflect an arms-length transaction? We may want to apply tax shelter tactics in adjusting rent, interest, etc. assuming certain leases are approved.

14. Does section 277 apply to cooperatives?

15. What method of income and expense allocation applies in section 277 situations?

- a. A test patterned after the 85% member income test.
- b. A test patterned after the patronage sourced income test.
- c. A test used in state rate making cases.

16. Can both ITC and ETC be passed through to [REDACTED]'s patrons in a situation where [REDACTED] cannot use the credits?

17. Are credits subject to allocation for the various purposes under consideration in this case?

18. If credits can be allocated, what method of allocation is applicable under the facts of this case where full member usage of assets does not occur until ten years after the assets are placed in service and these assets generate a substantial amount of nonmember income during the first five years of the assets' useful life? The situation is further complicated by statements made by [REDACTED] to [REDACTED] to the effect that assets are being purchased for member use in order to gain [REDACTED] financing.

19. If credits available to [REDACTED] are divided between member and nonmember activities, does section 46(h) prohibit all credits from being carried back and forward? If an allocated credit cannot be used by [REDACTED], is it required to be allocated to [REDACTED]'s patrons?

20. What is the status of credits generated during periods of time that [REDACTED] was exempt from taxation under section 501(c)(12)? A study of [REDACTED]'s activities as of [REDACTED] would indicate that [REDACTED] would be expected to be a taxable entity in some years and a nontaxable entity in other years. Should this expectation have anything to do with the calculation of credits and is the Internal Revenue Service justified in spreading both deductions and credits over the lives of the assets involved under section 277?

21. If a patronage dividend is allocated to a taxable patron entity under the accrual method of accounting, should the Internal Revenue Service require this entity to include the dividend in its income in the year accrued?

22. Does [REDACTED] operate on a cooperative basis under the following situation: Patronage dividends are based on kilowatt hours used by customers; while all customers do not pay the same rate per kilowatt hour of electricity consumed? Can this be used to attack [REDACTED]'s tax status?

FACTS

According to materials supplied by the Special Trial Attorney, [REDACTED], initially called [REDACTED], is an electric power generation and transmission cooperative organized under the [REDACTED]. [REDACTED] was organized on [REDACTED], for the purpose of developing large scale, economical generating plants to provide at wholesale and on a nonprofit basis the power supply requirements of its [REDACTED] cooperative members. All of the members of [REDACTED] are electric distribution cooperatives, and these members operate in [REDACTED] of the [REDACTED] counties of [REDACTED]. Each member cooperative is represented by a separate director on [REDACTED]'s board of directors.

In [REDACTED] of [REDACTED], [REDACTED] purchased an undivided [REDACTED]% interest in [REDACTED] and [REDACTED] and the common facilities at the [REDACTED] Fuel Plant ("Plant [REDACTED]") near [REDACTED]. The other owners of Plant [REDACTED] were [REDACTED], who had an undivided [REDACTED]% interest, [REDACTED], who had an undivided [REDACTED]% interest, and the City of [REDACTED], who had an undivided [REDACTED]% interest. The Ownership Agreement for Plant [REDACTED] specified that each participant held title to Plant [REDACTED] as a tenant in common and that each participant was entitled to its pro rata share of the energy and capacity of the plant. Each participant was also required to pay its obligations arising from the ownership and operation of the plant.

The participants also entered into an Operating Agreement on [REDACTED]. The Operating Agreement provided that [REDACTED] would have the responsibility for managing and operating the plant as agent for the participants. The participants owning [REDACTED] % of Plant [REDACTED] had the right to remove [REDACTED] as the plant operator under certain circumstances.

The Operating Agreement recognized that each of the participants was entitled to a percentage of the capacity and energy output of the plant equal to its undivided ownership interest. Each participant was also responsible for the payment of its respective percentage costs of operating the plant.

Furthermore, pursuant to the Operating Agreement, [REDACTED] agreed to transfer to [REDACTED] a decreasing portion of its energy and capacity derived from Plant [REDACTED] during the first ten years of each unit's commercial operation. [REDACTED] asserts that the transfer of a declining amount of generating capacity benefited it economically by permitting a gradual phase in of generating capacity to meet expected load growth and that the declining transfer minimized the effect of high costs associated with new generating capacity. As consideration for the transfer of plant capacity and energy, [REDACTED] agreed to compensate [REDACTED] by making monthly "capacity payments" and by becoming responsible for an allocable portion of [REDACTED]'s liability for operating costs and fuel costs.

Capacity payments were determined by a formula involving [REDACTED]'s investment in the plant, the proportion of [REDACTED]'s energy and capacity transferred and [REDACTED]'s and [REDACTED]'s capital costs with respect to [REDACTED]'s and [REDACTED]'s investment in the plant. The operating costs [REDACTED] was obligated to pay included all costs and expenses incurred in the management, control, operation and maintenance of the unit which were allocable to the capacity and energy transferred to [REDACTED]. The fuel costs [REDACTED] was obligated to pay included all costs incurred for the acquisition, handling, storage and disposal of fuel which were allocable to the capacity and energy transferred to [REDACTED].

Both units [REDACTED] and [REDACTED] at Plant [REDACTED] are coal burning electric generators. Construction was completed and Unit [REDACTED] was synchronized into the main power grid of the [REDACTED] on [REDACTED] (synchronization date). However, due to mechanical problems with the generator, Unit [REDACTED] was not put into commercial use until [REDACTED] (commercialization date). The synchronization date for Unit [REDACTED]

was [REDACTED], but due to mechanical problems its commercialization date was [REDACTED].¹

[REDACTED] entered into three section 168(f)(8) safe harbor leases with respect to its [REDACTED] interest in Unit [REDACTED] and the common facilities at Plant [REDACTED]. The leases with [REDACTED] and [REDACTED] began on [REDACTED]. The lease with [REDACTED], a public Utility, began on [REDACTED].

Safe harbor leases were created by the Economic Recovery Tax Act of 1981 to allow an owner of property who was unable to use investment tax credits or accelerated depreciation (because he had little or no taxable income) to pass such benefits to other taxpayers who could use such benefits. Pursuant to the safe harbor leases, [REDACTED] transferred portions of its interest in Unit [REDACTED] and the common facilities to [REDACTED], [REDACTED] and [REDACTED], solely for tax purposes ([REDACTED] retained legal title), and [REDACTED] and [REDACTED] in turn leased the property back to [REDACTED]. As was the practice under most safe harbor leases, [REDACTED], [REDACTED] and [REDACTED] purchased the property by making a lump sum payment to [REDACTED] and by giving [REDACTED] promissory notes bearing interest. [REDACTED] then leased the property from [REDACTED], [REDACTED] and [REDACTED] for an amount equal to the payments of principal and interest on the notes. Thus, the only money that was actually exchanged under the leases was the initial lump sum payments.

[REDACTED] was recognized as exempt from federal income taxation under section 501(c)(12) since its creation. However, [REDACTED] requested and received a private letter ruling (dated August 23, 1982) which held that the capacity payments and [REDACTED]'s share of the operating and fuel costs paid by [REDACTED] pursuant to the Operating Agreement for Plant [REDACTED], was nonmember income for the purpose of the 85 percent member income requirement under section 501(c)(12). Based on this ruling [REDACTED] determined that it failed to meet the 85 percent member income requirement and that it was a taxable entity for taxable years 1982 and thereafter. It therefore discontinued filing Form 990s (return for organizations exempt from income tax under section 501(c)) and began filing Form 1120s (corporate income tax return) in 1982.

[REDACTED] requested and received another private letter ruling (dated [REDACTED]) which held that property owned by it was not public utility property within the meaning of sections

¹ The issue of whether the "placed in service" date is the synchronization date or the commercialization date for the purposes of the section 168(f)(8) safe harbor leases (see discussion, *infra*) was addressed in a memorandum from the Director, Tax Litigation Division to Regional Counsel, Southeast, Attn: [REDACTED] dated July 22, 1988.

461(f)(5) or 168(g)(1) because [REDACTED]'s rates for the sale of energy were not established or approved by a regulatory body.

[REDACTED]'s purpose in obtaining these two rulings was to insure its ability to transfer the investment credits and accelerated depreciation under the safe harbor leases. The amount of investment credit available to tax exempt organizations is limited under section 48(a)(4) and, thus, the amount of credit that [REDACTED] could have transferred, as an exempt organization, was also limited. Accelerated depreciation is also unavailable to an exempt organization. With respect to public utility property, the investment credit, including the energy credit, is limited by sections 46(c)(3) and 48(l)(17). And, accelerated depreciation for public utility property is limited by section 168(e)(3).

The notice of deficiency covers taxable years [REDACTED]. In the notice, the Service held that [REDACTED] failed the 85 percent member income requirement under section 501(c)(12) for taxable years [REDACTED] and [REDACTED] because of income from agreements with [REDACTED] for the operation of Plant [REDACTED] and Plant [REDACTED]. (These agreements were similar to the agreement to operate Plant [REDACTED].) Thus, the notice held that [REDACTED] was a taxable corporation for taxable years [REDACTED] and [REDACTED]. (Of course, [REDACTED] was also a taxable entity for taxable years [REDACTED] and [REDACTED], as intended by [REDACTED] in order to sell the investment credit and accelerated depreciation via the safe harbor leases.)

The notice also held that:

- 1) the capacity payments and [REDACTED]'s share of the operating and fuel costs paid by [REDACTED] under the various agreements with [REDACTED], were nonpatronage sourced income to [REDACTED] and, therefore, amounts allocated to [REDACTED]'s patrons derived from such income were not subject to a patronage dividend deduction;
- 2) expenses related to the operating agreements were nonpatronage sourced expenses which could not be included in patronage sourced expenses;
- 3) income and expenses related to the safe harbor leases were nonpatronage sourced income and expenses;
- 4) the basis of a qualified investment for purposes of the investment credit must be allocated between that portion of the property used to produce power for patrons and that portion used to produce power for nonpatrons (the notice held that the investment credit was not available for that portion allocated to patronage use); and
- 5) the notice asserted various other deficiencies in [REDACTED]'s income tax for taxable years [REDACTED].

█████ contests most of these findings in its petition filed with the Tax Court on █████.

Your request for tax litigation advice concerns the taxation of nonexempt rural electric cooperatives. This request is the third tax litigation advice requested by you. The first request concerned the placed in service date of Plant █████ for the purposes of the safe harbor leases and the second request concerned a variety of issues including the validity of the safe harbor leases, the availability of the investment and energy credits to █████ or the safe harbor lessors and elections made by █████.

DISCUSSION

The following discussion addresses the issues framed by your request in the order in which you presented them. Issues 1, 3, 4, 14, 15 and 20 were addressed by Ronald Weinstock (CC:TL:Br4).

Issues 1 and 3:

The Special Trial Attorney's query is whether in applying the 85 percent test under I.R.C. § 501(c)(12), there must be a direct sourcing of income from members. Section 501(c)(12) requires that 85 percent of the organization's income be collected from members for the sole purpose of meeting losses and expenses and does not discuss it in terms of being member sourced. We read the question relating to the "sourcing" of income as asking whether certain income may be considered member sourced in the same manner that interest or other income may be considered patronage income because the activity it derives from is so intertwined with business done by the cooperative with its patrons. See St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041 (Ct. Cl. 1980); Cotter & Company & Subsidiaries v. United States, 765 F.2d 1103 (Fed. Cir. 1985). We do not believe the reasoning applicable as it conflicts with section 501(c)(12).

Service position is that there must be a direct sourcing of income which is collected for the sole purpose of meeting losses and expenses. Allgemeiner Arbeiter Verein v. Commissioner, 25 T.C. 371, 375 (1955), aff'd, 237 F.2d 604 (3rd Cir. 1956) (amounts collected from members for recreational purposes were not collected for the sole purpose of meeting losses and expenses). Other income is "non-member" income for purposes of the 85 percent test under section 501(c)(12). See Lower Yucaipa Water Co. v. United States, 32 AFTR2d 73-5803 (USDC DC Cal. 1973) (interest income not member income); Mountain Water Company of La Crescenta v. Commissioner, 35 T.C. 418 (1960) (capital gain from the sale of operating assets is not member income).

We note that certain member sourced income is not considered to be collected from members for the sole purpose of meeting losses and expenses. G.C.M. 39416, [REDACTED] EE-128-84 (May 31, 1985), held that payments received for the sale of electricity at less than cost by a federation of rural cooperatives to a member cooperative formed by other members of the federated cooperative and an unrelated organization which in turn resells the electricity to the unrelated organization constituted nonmember income for purposes of the 85 percent member income test. In [REDACTED], then, insofar as certain payments from the sale of electricity to a member is nonmember income, it follows that capacity payments, payments of operating costs and payments of fuel costs received by a private power company (and not a member) in exchange for the transfer of [REDACTED]'s energy and capacity is nonmember income.

Issue 2:

No above the line adjustment for patronage dividends should be made before applying the 85 percent member income test of section 501(c)(12). Treas. Reg. § 1.501(c)(12)-1(a)(last sentence) ("On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.")

Issue 3:

The discussion of this issue is addressed in the discussion under Issue 1.

Issue 4:

We agree with the positions set forth in the undated memorandum from CC:EE to CC:CT provided by the Special Trial Attorney.

Issue 5:

Section 1381(a)(2)(C) exempts rural electric cooperatives from treatment under Subchapter T. [REDACTED] is a rural electric cooperative and, thus, is not within the scope of Subchapter T. See Rev. Rul. 83-135, 1983-2 C.B. 149.

The legislative history to Subchapter T states that cooperatives exempt from Subchapter T are to be treated "the same as under present law." S. Rep. No. 1881, 87th Cong., 2d Sess. 707, 819 (1962); 1962-3 C.B. 707, 819. Subchapter T was enacted as part of the Revenue Act of 1962.

"Present law" in 1962 with respect to the instant issue is embodied in Rev. Rul. 59-322, 1959-2 C.B. 154, which states at page 155:

that allocations and notifications of patronage dividends, made pursuant to a pre-existing obligation by a nonexempt cooperative (that is a cooperative not exempt from tax under section 521) after the close of the taxable year in which such patronage occurred, will be considered as made before the end of such taxable year if made on or before the due date for filing the Federal income tax return (including any extension of time) for the year in which such patronage occurred. Accordingly, such patronage dividends will be excluded from the income of the cooperative for that year.

██████ is a "nonexempt cooperative" as that term is used in Rev. Rul. 59-322. See Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 318 (1965); Consumer Credit Rural Electric Cooperative Corporation v. Commissioner, 37 T.C. 136, 145 (1961).

"Allocations and notifications" are defined for the purposes of cooperatives not covered by Subchapter T in Rev. Rul. 54-10, 1954-1 C.B. 24 and Treas. Reg. § 1.65-5(a). Allocations and notifications can be in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or similar documents.

Thus, an allocation and notification to a patron by ██████ before it filed its income tax return for any of the taxable years at issue is a patronage dividend excludable from income if made pursuant to patronage occurring during such taxable year.²

For a further discussion of the notification issue, see discussion under Issue 9, infra.

² It should be noted that rural electric cooperatives exempt from tax under section 501(c)(12) are not required under that section to give notice to its members of allocations of earnings to them. Neither are such exempt cooperatives required under section 501(c)(12) to make yearly patronage dividends based on patronage that has occurred during such year. See I.R.M. 7751(12)32(2). However, a patronage dividend deduction is not an issue for such cooperatives. But see Rev. Rul. 72-36, 1972-1 C.B. 151, which states that an exempt rural electric cooperative must, generally, be operated on a cooperative basis.

Issue 6:

As stated above, payments, allocations and notifications of patronage dividends are defined for cooperatives not covered by Subchapter T in Rev. Rul. 54-10, 1954-1 C.B. 24 and Treas. Reg. § 1.61-5(a). A patronage dividend can be in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or similar documents. Furthermore, there is no requirement that a portion of the patronage dividend be in cash, as is required by Subchapter T.

Issue 7:

█████ cannot charge any finally determined increase to its income, pursuant to the notice of deficiency or a court decision, to deductible patronage dividends. See Rev. Rul. 74-327, 1974-2 C.B. 173. The fact pattern in the instant case is as follows.

The years in suit in the instant case are taxable years █████ through █████. The notice of deficiency for those years was issued by the Service on █████. The notice holds that █████ has additional patronage sourced income. The Tax Court may finally decide in this case that █████ has either less or more patronage sourced income than it originally claimed on its tax returns for the years in suit. █████ claims in its petition that if it is finally determined that it had more patronage sourced income than it originally claimed on its tax returns for any of the years in suit, that it should be allowed a patronage dividend deduction for that amount because if it had known that it had additional patronage sourced income during any of the years in suit, it would have paid or allocated the dividends during those years and would have been required, pursuant to its by-laws, to do so.

█████'s argument is flawed. As stated in the discussion for Issue 5, supra, and as addressed more fully in the discussions for Issues 8 and 9, infra, Rev. Rul. 59-322, 1959-2 C.B. 154, requires that allocation of patronage dividends be within the time for filing the cooperative's tax return for the year in which the patronage occurred. If it is finally determined that █████ had additional patronage sourced income for any of the years in suit, █████ would not be allowed a deduction for a patronage dividend made thereafter because clearly the dividend would be paid or allocated long after the year in which the patronage occurred.

In this context, it should be noted that patronage dividends are an economic concept that exists in state corporate law. The federal income tax treatment of cooperatives merely follows the economic substance of transactions. If █████ did not pay or

allocate a patronage dividend on the excess amount within the deadline prescribed in Rev. Rul. 59-322, it cannot now make such a dividend and claim it was made within the deadline. It should also be noted that the above outlined position mirrors the treatment afforded by Subchapter T. See Rev. Rul. 74-327.

Issue 8:

The amount of a patronage dividend may be excluded from the gross income of a cooperative if the patronage dividend is paid or allocated, and notification is given to the patron, pursuant to a preexisting legal obligation. Rev. Rul. 83-135, 1983-2 C.B. 149.

The preexisting legal obligation must exist before the receipt of the funds that are later distributed as a patronage dividend. Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. 674, 686 (1958); aff'd, 288 F.2d 326 (8th Cir. 1961); United Cooperatives, Inc. v. Commissioner, 4 T.C. 93 (1944), acq., 1945 C.B. 6. If the duty does not exist at the time the funds are received, no deduction is allowed for the patronage dividend. ³

³ The Tax Court's opinion in Pomeroy is often cited and one particular part, which discusses the requirement for patronage dividends, is often quoted. In order for a patronage dividend to be deductible:

First, the allocation must have been made pursuant to a preexisting legal obligation; that is to say, it must have been made pursuant to a legal obligation which existed at the time when the participating patrons transacted their business with the cooperative, and not pursuant to an obligation created after the allocated amount was earned. [citations omitted] Second, the allocation must have been made out of profits or income realized from transactions with the particular patrons for whose benefit the allocations were made, and not out of profits or income realized from transactions with other persons or organizations which were not entitled to participate in such allocations. [citations omitted] And third, the allocations must have been made equitably; so that profits realized on the one hand from selling merchandise or services to patrons, and those realized on the other hand from marketing products purchased from patrons, were allocated ratably to the particular patrons whose patronage created each particular type of profit.

Pomeroy, 31 T.C. at 686.

Thus, a provision in the corporate charter, by laws, or some other contract that mandates the payment of patronage dividends, that exists before receipt of the funds that are later distributed as a patronage dividend, is a sufficient preexisting legal obligation which would allow the cooperative to take a deduction for the distribution.

A mere resolution by the board of directors is insufficient because only those corporations that are operated on a cooperative basis are allowed to exclude patronage dividends from income. See Rev. Rul. 83-135; Rev. Rul. 54-10, 1954-1 C.B. 24. To allow corporations who do not normally operate on a cooperative basis to deduct dividends upon a resolution by the board of directors would open this area to abuse.

This treatment of what is a sufficient preexisting legal obligation is analogous to the treatment afforded Subchapter T cooperatives under section 1388(a)(2) and Treas. Reg. § 1.1388(a)(1).

It is also the Service's position that notice must be given to a patron in order for the patronage dividend to be excluded from the gross income of the cooperative. Rev. Rul. 59-322, 1959-2 C.B. 154. See discussion under Issue 9, infra.

The requirement of a notice to patrons for non Subchapter T cooperatives also parallels the requirements in Subchapter T. See sections 1382(b) and (d).

Thus, the facts in paragraphs a. and b. in Issue 8 would be sufficient to meet the preexisting duty requirement although some evidence of notice to the patron would also be required to substantiate a patronage dividend deduction.

The facts in paragraph c. and d. do not meet the pre-existing duty requirement because, as stated above, a resolution by the board of directors is not sufficient as a preexisting duty. Furthermore, no notice was given to the patrons.

The facts in paragraphs e. and f. would not allow [REDACTED] to take a patronage dividend deduction because no notice was given to the patrons.

The facts in paragraph g. would not allow [REDACTED] to take a deduction because the due date for making the patronage dividend expired when it filed its return and no notice was given to the patrons.

Assuming a preexisting duty existed for making the patronage dividend and the allocation and notification took one of the forms listed in Treas. Reg. § 1.61-5(a) (i.e., cash,

merchandise, capital stock, revolving fund certificates, etc.), the facts in paragraph h. would allow [REDACTED] to take a patronage dividend deduction.

The facts in paragraph i. would also allow [REDACTED] to take a deduction assuming the facts assumed above for the discussion under paragraph h.

The facts in paragraph j. do not allow [REDACTED] to take a deduction because [REDACTED] failed to pay or allocate the dividend on or before the filing date (assuming any properly obtained extensions) of its return.

Issue 9:

As stated above, patrons are required to be notified of patronage dividends and notification is required to be in one of the forms listed in Treas. Reg. § 1.61-5(a); i.e., cash, merchandise, capital stock, revolving fund certificates, etc. Rev. Rul. 59-322, 1959-2 C.B. 154. (See discussion under Issues 5 and 8.) The notification must disclose to the patron the dollar amount allocated. Treas. Reg. § 1.61-5(a); Rev. Rul. 54-10, 1954-1 C.B. 24 at page 25.

Several cases have addressed the notification requirement specifically. Farmers Cooperative Company v. Commissioner, 33 T.C. 266 (1959), rev'd, 288 F.2d 315 (8th Cir. 1961); Lake Forest, Inc. v. Commissioner, T.C. Memo. 1963-39; an unreported decision Certified Grocers of Florida, Inc. v. United States, 66-2 U.S.T.C. para. 9493 (M.D. Fla. 1966). In Farmers Cooperative, which involved years before Rev. Rul. 59-322 was published, the Eighth Circuit reversed the Tax Court and held that there was no deadline for allocation of patronage dividends and no notification requirement in order for a cooperative to take a patronage dividend deduction.

In Certified Grocers, the District Court did not accept Rev. Rul. 59-322 as an accurate interpretation of the law and held that there was no requirement that patronage dividends be allocated and patrons notified before the filing of the cooperative's tax return.

In Lake Forest, the Tax Court reiterated its holding in Farmers Cooperative that "one necessary element of allocation of patronage is disclosure to the patron of the dollar amount apportioned to him...." Lake Forest T.C. Memo. 1963-39 at 166. However, the Court, in a partial rejection of Rev. Rul. 59-322, held that allocation and notification of patronage dividends within a year of the end of the taxable year in which the patronage occurred (as opposed to before the tax return is filed) was "timely." (The Court, in effect, rejected the Eighth

Circuit's holding in Farmers Cooperative although the Tax Court stated that it was unnecessary to decide whether to follow the Eighth Circuit because the allocation and notification in Lake Forest was within one year. Lake Forest, at 167.)

The Service agrees with the Tax Court that allocation and notification of patronage dividends is a prerequisite to taking a patronage dividend deduction. However, the Service still adheres to its position in Rev. Rul. 59-322 that allocation and notification must be before the filing of the cooperative's tax return. Farmers Cooperative involved taxable years before Rev. Rul. 59-322 was published and, therefore, is not relevant and Certified Grocers is an unpublished opinion and should not be given much weight.

It should also be noted that to take a contrary position would open the Service to the kind of whipsaw that is exemplified by Long Poultry Farm, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957); i.e., the cooperative excludes a patronage dividend from income but the patron does not include the dividend in its income. Under Treas. Reg. § 1.61-5(a) and (b) notice to a patron must be received by the patron before it is required to include the dividend in its income. To allow the cooperative to exclude the dividend from income without giving notice to the patron would, therefore, cause the Long Poultry problem.

The Tax Court recognized this problem in both Farmers Cooperative and Lake Forest. The Court, in Lake Forest, quoted Farmers Cooperative and reasoned that a patronage dividend deduction was premised upon prompt notification of the patron because " 'the pattern of taxation adopted by Congress in section 101(12)(B) of the 1939 Code and section 522(b)(2) of the 1954 Code, with respect to the taxation of the refundable earnings of exempt cooperative associations indicates a congressional intent to tax to the individual patron his share of a patronage refund deducted by the cooperative.' [Farmers Cooperative,] 33 T.C. at 270. In this we were supported by the 1951 Revenue Act Finance Committee Report, supra, [S. Rep. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 473.] which stated, at p. 21, "As a result of this action, [the amendment adopted by the 1951 Revenue Act] all earnings or net margins of cooperatives will be taxable either to the cooperative, its patrons or its stockholders * * * " Lake Forest, T.C. Memo. 1963-39, 22 T.C.M. (CCH) 156, 166.

Such cases as Long Poultry caused Congress to enact Subchapter T to clarify that all earnings of cooperatives would be taxable either to the cooperative, its patrons or its stockholders. In fact, the Senate Finance Committee Report to Subchapter T states: "In 1951 Congress passed legislation which taken together with prior Treasury rulings, it generally

was thought insured that earnings of cooperatives would be currently taxable (to the extent they reflected business activity) either to the cooperative or to the patrons. However, certain court decisions...[the Report went on to discuss the effect of Long Poultry and other decisions]." S. Rep. No. 1881, 87th Cong., 2d Sess. 707, 819 (1962), 1962-3 C.B. 707, 819. Furthermore, the legislative history to Subchapter T states that "present law" (i.e., the law before the enactment of subchapter T) allowed a cooperative a deduction for patronage dividends only if "paid during the taxable year in which the patronage occurred, or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted)." H. Rep. No. 1447, 87th Cong., 2d Sess. 405, 484 (1962), 1962-3 C.B. 405, 484; S. Rep. No. 1881, 87th Cong., 2d Sess. 707, 819, 1963-3 C.B. 707, 819.

Thus, both Congress and the Tax Court believed before the enactment of Subchapter T that prompt allocation and notification of patronage dividends was a prerequisite to obtaining a deduction and Congress reiterated this belief in enacting Subchapter T.

Issue 10:

All the items of income listed in Issue 3 are nonpatronage sourced income because none of the items involve a transaction which resulted in a partial rebate of the cost of electricity purchased by ■■■'s patrons.

In order to understand what is meant by the term "patronage sourced income," a review of the history of the term is essential.

In 1938, the Service stated in I.T. 3208, 1938-2 C.B. 127, declared obsolete by Rev. Rul. 70-293, 1970-1 C.B. 282, that: "Under long established Bureau practice, amounts payable to patrons of cooperative corporations as so called patronage dividends have been consistently excluded from the gross income of such corporations. The practice is based on the theory that such amounts in reality represent a reduction in cost to the patron of goods purchased by him through the corporation or an additional consideration due the patron for goods sold by him through the corporation."

Implicit in the above quoted phrase is the assumption that cooperatives come in two basic forms. Cooperatives that sell products or services to its patrons (a purchasing cooperative) and cooperatives that sell products produced by its patrons (a marketing cooperative). Thus, true patronage dividends were limited to amounts that represent a partial rebate in the

purchase price of products or services sold to patrons or additional compensation for products sold for patrons. ⁴

This rule was reiterated in Rev. Rul. 54-10, 1954-1 C.B. 24 and was the basis for section 522.

Prior to 1951, farmers' cooperatives were completely exempt from tax under section 101(12)(A) of the 1939 Code. However, Congress was concerned that farmers' cooperatives were accumulating substantial, tax-free reserves. In response, Congress enacted section 101(12)(B) (section 522 of the 1954 Code). The Senate Finance Committee Report to the Revenue Act of 1951 states:

Section 314 of your committee's bill continues the exemption [for farmers' cooperatives] provided by section 101(12) of the [1939] Code but removes from its application earnings which are placed in reserves or surplus and not allocated or credited to the accounts of patrons. In addition to being tax-free with respect to patronage dividends paid or allocated to patrons, as is generally also true in the case of other cooperatives, the cooperatives coming under section 101(12) are also to remain exempt with respect to amounts allocated to patrons where the income involved was not derived from patronage, as for example in the case of interest or rental income, and income derived from business done with the Federal Government. Moreover, they will not be taxed in any way with respect to reserves set aside for any necessary purpose, or reserves required by State law, if such reserves are allocated to patrons. [emphasis supplied]

S. Rep. No. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 472-473.

The above quoted committee report also contains the first description of nonpatronage sourced income; i.e., "interest or rental income, and income derived from business done with the Federal Government." This language was included in Treas. Reg. §

⁴ The Tax Court, in Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. 674, 685-686 (1958), stated:

...true patronage dividends are, in reality, either (a) additions to the prices initially paid by the cooperative to its patrons for products which the patrons had marketed through the cooperative, or (b) refunds to patrons of part of the prices initially paid by them for merchandise or services which they had obtained through the cooperative.

1.522-2(d) in defining "nonpatronage sourced income" for exempt farmers' cooperatives.

Subchapter T replaced section 522 and expanded its coverage to cooperatives other than just exempt farmers' cooperatives. Courts have consistently held that Subchapter T merely codified existing law as to the definition of "patronage sourced income." Iberia Sugar Cooperative, Inc. v. United States, 480 F.2d 548, 550 (5th Cir. 1973); Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, 403 F.n. 4 (1972), aff'd, 481 F.2d 812 (10th Cir. 1972), cert. denied, 414 U.S. 1028 (1973). Because the concept of patronage sourced income was merely carried over into Subchapter T from prior law, the test for non Subchapter T cooperatives should be the same as the test for Subchapter T cooperatives. Furthermore, the question of whether a particular item of income is patronage or nonpatronage sourced has been addressed both by the Service and the courts primarily within the scope of Subchapter T.

Section 1388(a)(1) defines a patronage dividend as an amount paid to a patron on the basis of quantity or value of business done "with or for" such patron.⁵ (Income from business done "with or for" patrons is commonly referred to as "patronage sourced income.") Treas. Reg. § 1.1382-3(c)(2) defines income derived from sources other than patronage as:

incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

The above definition, although limited by the regulation to cooperatives exempt from tax under section 521, has been used by the Service and the courts as a guide for Subchapter T cooperatives, generally. Rev. Rul. 69-576, 1969-2 C.B. 166; Illinois Grain Corporation v. Commissioner, 87 T.C. 435, 451 (1986).

Despite the apparently clear language of section 1388(a)(1) and Treas. Reg. § 1.1382-3(c)(2), confusion still existed as to

⁵ The phrase "with or for" as used in section 1388(a)(1) was first used in Treas. Reg. §§ 1.522-1(b)(1) and (4) and refers to the primary functions of purchasing cooperatives (business done "with" a patron) and a marketing cooperatives (business done "for" a patron).

the definition of "patronage sourced income." In response, the Service published Rev. Rul. 69-576, 1969-2 C.B. 166. In Rev. Rul. 69-576, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives, which was itself a cooperative and in which the farmers' cooperative was a member. The farmers' cooperative borrowed the money in order to purchase supplies for resale to its own patrons. (Thus, the farmers' cooperative was a purchasing cooperative.) The bank for cooperatives made a patronage dividend to the farmers' cooperative based on the amount of interest paid by the farmers' cooperative on loans received by it. The farmers' cooperative then paid this amount as a patronage dividend to its own members.

In holding that a deduction was permitted on the patronage dividend paid by the farmers' cooperative to its patrons the ruling states:

The classification of an item of income as from either patronage or non-patronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from non-patronage sources.

The ruling then states that the income received by the farmers' cooperative resulted from a transaction that "directly facilitat[ed] the accomplishment of the cooperative's purchasing activities."

The main point of the revenue ruling is that the patronage dividend from the farmers' cooperative to its patrons represents a reduction in the cost of supplies purchased from the cooperative. Part of the original cost paid by the farmers' cooperatives' patrons was the cost the farmers' cooperative paid in the form of interest on the loan to purchase the supplies. When the cost of the loan was reduced, this reduction in cost was passed on to the farmers' cooperative's patrons. The reduction in cost was a rebate on the cost paid by the farmers' cooperative's patrons for the supplies. Thus, the amount that was the subject of the patronage dividend was the result of a transaction (the loan) "directly related" to the "purchasing activity" of the farmers' cooperative. Thus, the activity was "for" such patrons as that term is used in section 1388(a)(1).

As part of the Tax Reform Act of 1969, Congress enacted section 277. The first sentence of section 277(a) states: "In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members...."

The Service's position is that section 277 applies to cooperatives because Congress intended the term "membership organizations" in section 277 to have a broad meaning. See discussion under Issue 14, infra. In fact, Congress enacted section 277 in response to a Ninth Circuit holding that allowed a mutual irrigation company, who (similar to [REDACTED]) lost its tax exempt status under section 501(c)(12).

In that case, Anaheim Union Water Company v. Commissioner, 35 T.C. 1072 (1961), rev'd in part, 321 F.2d 253 (9th Cir. 1963), the petitioners purchased tracts of land along the Santa Ana River, to protect their interests in the River's flow. The petitioners then leased the property to unrelated parties and in return received rental income. In order to offset this rental income, the petitioners intentionally charged their members below cost for water and, thus, the petitioners claimed they had no taxable income in the years at issue.

In a somewhat different approach than is now taken under section 277, the Service argued that the petitioners' expenditures above the amount collected from their members were not ordinary and necessary. The Ninth Circuit, in reversing the Tax Court, held that the expenditures were ordinary and necessary. The Ninth Circuit recognized the fact that the leased land was necessary to the petitioners' business and "though not acquired for investment or income purposes,...turned out to be sources of income to Anaheim." Anaheim, 321 F.2d at 256.

Congress rejected the holding in Anaheim in section 277 by limiting deductions for expenses from member business to "income derived...from members or transactions with members...." The Conference Report is even more strict when it states that deductions for expenses from member business is "allowed only to the extent of the income received from these members." H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 644, 652-653. Thus, under section 277 rental income received from property, even if that property is used in the business of the membership organizations, is nonmember income.

The Service's position is that in the instant case, member income for the purposes of section 277 is equivalent to patronage sourced income. In the instant case, a patronage dividend is merely the return to the patron of an amount already paid to [redacted] to purchase electricity.

In the instant case, the capacity and energy payments, [redacted]'s share of the operating expenses paid by [redacted] and the parity payments paid by [redacted] and [redacted] were not the result of a transaction "directly related" to the "purchasing activity" of [redacted] because the income does not represent a partial rebate of the cost of electricity purchased from [redacted] by its patrons. The income was not originally collected from members but was the result of a transaction that produced incidental income to [redacted]. Therefore, such amounts could not be the subject of a patronage dividend.

In other words, the income was not the result of a reduction in the cost paid by [redacted]'s patrons for electricity, which [redacted] merely passed on to its patrons. (This is the analogy to Rev. Rul. 59-576). The income is instead analogous to rent from the lease of property, which is "income derived from sources other than patronage" as defined in Treas. Reg. § 1.1382-3(c)(2) and which would not be member income under section 277. [redacted] in fact, analogized the operating agreement for Plant [redacted] to the "rental of a manufacturing facility" in its letter to the Service, dated July 6, 1982, pursuant to [redacted]'s request for a private letter ruling on whether it was an exempt organization. Rental payments are normally not patronage sourced income because such income usually does not represent a reduction in cost to the patrons of goods or services purchased from the cooperative or additional consideration due the patrons for goods sold by the cooperative.

Alternatively, it could be argued that the sale of the capacity of the various plants to [redacted] was, in substance, the sale of electricity to [redacted], who is not a patron of [redacted]. The product [redacted] sells to its patrons is electricity. It is well established that if a purchasing cooperative sells products to nonpatrons the income derived therefrom is nonpatronage sourced income. Rev. Rul. 68-228, 1968-1 C.B. 385, modified by 72-602, 1972-2 C.B. 510. Thus any income derived from the sale of electricity to [redacted] would clearly be nonpatronage sourced income and [redacted] could not take a patronage dividend deduction based on the amounts received.

It should be noted that the Service is not arguing that the arrangement between [redacted] and [redacted] was economically imprudent. On the contrary, the Service recognizes that the arrangement was financially sound and could potentially reduce [redacted]'s cost of producing electricity. However, entering into financially

prudent transactions to lower costs for patrons does not necessarily turn nonpatronage sourced income into patronage sourced income.

For example, an analogous argument can be made regarding the sale of electricity to nonpatrons. Pursuant to economies of scale, often the more units of a product that are sold, the less per unit cost the seller incurs. (Often the reason is attributable to fixed overhead costs that can be spread over a larger number of units.) Thus, it is financially prudent to sell electricity to nonpatrons in order to lower the cost of the electricity sold to patrons. However, no one would dispute the conclusion that if [REDACTED] sold electricity to nonpatrons, the income received therefrom would be nonpatronage sourced.

Unfortunately, the courts, including the Tax Court, have expanded on the proper definition of patronage sourced income as outlined above. The two most recent decisions in the Tax Court on the instant issue are Illinois Grain Corporation v. Commissioner, 87 T.C. 435 (1986), and Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987). These cases present a severe litigating hazard on the issue of whether the income at issue is patronage sourced income.

In Illinois Grain, the taxpayer cooperative invested short term surpluses of cash derived from its day to day operations in short term debt instruments. The Court held that the interest on the instruments was patronage sourced. The Court stated: "The primary purpose here was not to 'invest,' but to find a temporary parking place for its surplus funds, consistent with safety and prudent money management" Illinois Grain, 87 T.C. at 460. The Court then stated: "In short, we are convinced that the petitioner's money management activities in this case were inseparably intertwined with the overall conduct of its cooperative enterprise, and the interest income which it earned was therefore patronage-sourced." Id. at 460.

The other issue in Illinois Grain, concerned the taxpayer's lease of barges which it subleased to a barge transportation company which in turn used the barges to transport the taxpayer's patrons' grain. The Court held that the taxpayer's leasing and subleasing of the barges was also not an " 'investment' in such barges, intended to produce merely passive rental income, but was an integral part of its overall cooperative activity in moving its patrons' grain to market." Id. at 461. Therefore, the income was patronage sourced.

In Certified Grocers, 88 T.C. 238, the taxpayer invested short term surpluses of cash derived from its day to day operations in short term debt instruments just as the taxpayer in Illinois Grain had done. Again the Court held that the interest

on the instruments was patronage sourced. The Court in Certified Grocers used the same test it used in Illinois Grain, which it cited as follows:

The test used by this Court to determine if income is patronage-sourced was set forth in Illinois Grain, where we indicated that income is patronage sourced if it is:

so closely intertwined and inseparable from the main cooperative effort that it may be properly characterized as directly related to, and inseparable from, the cooperative's principal business activity, and thus can be found to "actually facilitate" the accomplishment of the cooperative's business purpose. * * * [87 T.C. at 459].

We stated, conversely, that income is not patronage-sourced if it is derived from sources that:

have no integral and necessary linkage to the cooperative enterprise, so that it may fairly be said that the income from such activities does nothing more than add to the taxpayer's overall profitability.* * * [87 T.C. at 459.]

Our opinion in Illinois Grain indicates the analysis we apply in determining whether interest income is patronage-sourced.

Certified Grocers, 88 T.C. at 243.

The Service does not agree with the holdings in these cases. The Tax Court has expanded the definition of patronage sourced income beyond what has been the law since the earliest days of the Internal Revenue Code and what was assumed by Congress to be the law when it enacted Subchapter T and section 277.

Finally, the payments made pursuant to the safe harbor leases with [REDACTED], [REDACTED], [REDACTED] and [REDACTED] are clearly nonpatronage sourced income even under the Tax Court's text. The safe harbor leases had nothing to do with the accomplishment of [REDACTED]'s "purchasing activities" and merely enhanced the overall profitability of the cooperative. See Rev. Rul. 69-576; Certified Grocers, 88 T.C. at 243.

Issue 11:

The test for making income allocations between patronage and nonpatronage sourced income is the test outlined in the discussion under Issue 10, supra.

Issue 12:

The same test that is applicable to income allocations is also applicable to expense allocations. This conclusion is mandated by the definition of "patronage sourced income" and section 277. See discussion under Issue 10, supra.

Essentially, cooperatives must maintain two separate and distinct accounts: One for patronage sourced income and expenses and the other for nonpatronage sourced income and expenses. The reason for this is twofold. First, nonpatronage sourced income cannot be the subject of a patronage dividend deduction. Rev. Rul. 62-228, 1968-1 C.B. 385, modified by 72-602, 1972-2 C.B. 510; Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. 674, 686 (1958); aff'd, 288 F.2d 326 (8th Cir. 1961); Fruit Grower's Supply Company v. Commissioner, 21 B.T.A. 315 (1930), aff'd, 56 F.2d 90 (9th Cir. 1931). Furthermore, in determining the amount of a patronage dividend no deduction or loss from nonpatronage sourced expenses are allowed against patronage sourced income. Rev. Rul. 74-377, 1974-2 C.B. 274;; LTR 87-07-005 (Nov. 7, 1986); [REDACTED], GCM 39,610, I-177-84 (March 5, 1987).

Second, patronage sourced expenses cannot be used to offset nonpatronage sourced income. Farm Service Cooperative v. Commissioner, 619 F.2d 718 (8th Cir. 1980), reversing 70 T.C. 145 (1978); Certified Grocers of California, Ltd v. Commissioner, 88 T.C. 238 (1987); Section 277. See also LTR 86-41-005 (June 30, 1986). Otherwise, the cooperative could deliberately operate its business with its patrons at a loss and use that loss to offset income from a profitable business with nonpatrons.

The test for expense allocations is, therefore, the same as the test for income allocations in order to keep patronage sourced income and expenses separate from nonpatronage sourced income and expenses.

Issue 13:

a. In line with the position that the income from the safe harbor leases is nonpatronage sourced income (see discussion under Issue 10), expenses related to the safe harbor leases are nonpatronage sourced expenses.

b. A distinction must be drawn between interest on indebtedness incurred in the "purchasing activities" of [REDACTED] i.e., [REDACTED]'s patronage business, and interest on indebtedness incurred in [REDACTED]'s nonpatronage business. The former can offset only patronage sourced income and the latter can offset only nonpatronage sourced income. If the indebtedness was incurred to purchase property, a determination must be made as to what

percentage of the property's total output (i.e., power, products, resources, usable space) per year is used for patronage business and what percentage is used for nonpatronage business. The interest on the indebtedness should then be divided between patronage expenses and nonpatronage expenses on a yearly basis, based on this ratio.

c. If the safe harbor leases are held to be invalid, the same calculation as was used in paragraph b., above, should also be used here. A determination must be made as to what percentage of the total power produced each year by Plant [REDACTED] is used for patronage business and what percentage is used for nonpatronage business. The depreciation deductions should then be divided between patronage expenses and nonpatronage expenses on a yearly basis, based on this ratio.

On this issue, it should be noted that Congress has recognized that section 277 prohibits depreciation on cooperative housing to be used against nonmember income. Pursuant to the 1976 amendments to section 216(c), the Senate Finance Committee states:

The committee does not believe that a clarification of the rules relating to the cooperative housing corporation's ability to take depreciation deductions with respect to property leased to tenant-stockholders will create tax avoidance possibilities because the provisions of existing law (sec. 277) generally prevent nonexempt membership organizations from offsetting nonmember income with losses from dealings with members.

S. Rep. No. 938, t, Cong., 2d Sess. 1, 398 (1976), 1976-3 vol. 3 C.B. 57, 436. This citation is also evidence that Congress intended that section 277 apply to cooperatives.

Furthermore, taxable cooperatives may use accelerated depreciation. See Rev. Rul. 74-303, 1974-1 C.B. 243.

If the safe harbor leases are valid, no allocation would be required by the lessors ([REDACTED], [REDACTED], [REDACTED] and [REDACTED] because they are not cooperatives. It should be noted that [REDACTED] is allowed the full amount of the depreciation deductions (the rules outlined herein are merely allocation rules) and, thus, [REDACTED] can pass on the full amount of the depreciation deductions under the safe harbor leases.

d. If the safe harbor leases are held to be invalid, the investment credit should be allocated between patronage sourced income and nonpatronage sourced income in the same manner that depreciation deductions are allocated, as explained in the

discussion to paragraph c., above. See TAM 81-48-007 (Dec. 30, 1980). The rationale for allocating the investment credit between patronage and nonpatronage sourced income is the same for allocating expenses between patronage and nonpatronage sourced expenses; i.e., to avoid offsetting nonpatronage sourced income with patronage sourced items or patronage sourced income with nonpatronage sourced items.

An extremely abusive scenario would occur if a cooperative, which operated two business--one for patrons and the other for nonpatrons--placed in service property in its patronage business but distributed all of its income from that business in the form of patronage dividends. The cooperative could then use the investment credit from the property placed in service in its patronage business to offset income from its non patronage business. Furthermore, it would be a simple matter to use the property, in the year it was placed in service, in the nonpatronage business and then use the property in the patronage business during the remainder of the property's useful life in order to claim the investment credit (normally calculated in the year the property is placed in service) in the nonpatronage business.

In many cases, as in the instant case, the same piece of property may be used during its useful life in both the patronage and nonpatronage businesses of the cooperative. And, the percentage of usage allocable between the patronage and the nonpatronage business may vary from year to year. Thus, the issue is how to determine the allocation of the investment credit between the patronage and nonpatronage businesses of the cooperative in such a situation.

In such a case, a reasonable estimate must be made in the year the property is placed in service with respect to what portion of the total output of the property over it's useful life (determined under whatever method of depreciation is properly used by the cooperative) is used for patronage business and what portion is used for nonpatronage business. The investment credit should be allocated between patronage income and nonpatronage income based on this ratio. Any investment credits not utilized in year one would be carried back or forward and would maintain its patronage or nonpatronage character.

In the instant case, this estimate is already contained in the operating agreements between [REDACTED] and [REDACTED]. In the agreements, [REDACTED], in effect, leased its capacity in the various plants to [REDACTED] on a diminishing scale. The agreements specifically state what portion of the capacity of the plants was to be utilized by [REDACTED] and what portion was to be utilized by [REDACTED]. Thus, in the instant case, making the calculations as outlined above would be relatively easy.

If the safe harbor leases are valid, no allocation would be required by the lessors (, , and) because they are not cooperatives. Again, it should be noted that is allowed the full amount of the investment credits (the rules outlined herein are merely allocation rules) and, thus, OPC can pass on the full amount of the credits under the safe harbor leases.

It should be noted that if the capacity payments and 's share of the operating and fuel costs paid by are held to be patronage sourced income, the calculations in paragraphs c. and d., above, would not be necessary.

e. Safe harbor leases under section 168(f)(8) were, in effect, a legitimate tax shelter created by Congress and the transactions were deemed to be at arms length. Thus, the safe harbor leases at issue here should only be scrutinized to ensure that the express requirements of section 168(f)(8) were met.

Issue 14:

It is the Service's position that section 277 applies to cooperatives. We are presently litigating this question with respect to a Subchapter T farmer's cooperative (,).

. The application of section 277 to organizations which have lost their exemption under section 501(c)(12) seems clearer insofar as the legislative history of section 277 shows that it was enacted in part to overturn Anaheim Union Water Company v. Commissioner, 321 F.2d 253 (9th Cir. 1963). See 115 Cong. Rec. 37483 (1969) (statement of Senator Bennett); S. Rep. No. 552, 91st Cong., 1st Sess (1969), 1969-3 C.B. 423, 471. Anaheim was an organization which had lost its exemption under the predecessor of section 501(c)(12).

Issue 15:

You ask us what method of income and expense allocation applies in a section 277 situation. Three allocation methods are suggested by the Special Trial Attorney. We assume by an allocation method patterned after the 85 percent member income test that he is asking whether items of expense are linked with items of income so that if all income in a year from a power plant was nonmember income, all expenses in that year from the plant would be allocated to the nonmember income. We assume that by a test patterned after the patronage sourced income test he means we look to see whether the expense is attributable to an asset related to the member service activities of the members. Under this approach, even though income from a plant in a particular year may be nonmember income, because the plant is intended to provide electricity to 's members for most of its

useful life, the expenses should properly be treated as member related to that extent. We assume that a test patterned after the one used in state rate making cases would be one that makes use of industry practice in such allocations. An example would be the use of the Integrated Transmission Agreement (ITA) for cost causation of the transmission expenses as discussed in the fees proposal of [REDACTED]

Under the withdrawn proposed section 277 regulations, allocation of expenses was permitted on a reasonable and consistent basis. While these regulations were not finalized and there is no other authority, we believe this position is correct and consistent with general principles of tax accounting. The appropriate allocation method is a tax accounting question, the inquiry under section 277 being whether under the facts and circumstances a particular method used is a reasonable one, not what is the most reasonable accounting method. See Renssellaer Polytechnic Institute v. Commissioner, 731 F.2d 1058 (2d Cir. 1984).

In the instant case, the proper test is outlined in the discussion under Issue 10.

Issue 16:

[REDACTED] cannot pass through investment credits, including energy credits, to its patrons because section 46(h), which allows Subchapter T cooperatives to pass through credits, does not apply to [REDACTED] because it is not a Subchapter T cooperative.

Issue 17:

See discussion under Issue 13, paragraph d.

Issue 18:

See discussion under Issue 13, paragraph d.

Issue 19:

Section 46(h) does not apply to [REDACTED] because [REDACTED] is not a Subchapter T cooperative. Therefore, the investment credit is available to [REDACTED] as it would normally be available for any other corporation, except for the special allocations discussed above. Sections 46(a)(1) and 46(b) allow taxpayers, including [REDACTED] to carryback and carryover unused credits. However, as discussed above, in [REDACTED]'s case the unused credits would retain their patronage or nonpatronage character.

Issue 20:

This issue raises the question of what is the status of credits generated during the period of time [REDACTED] was exempt from tax under section 501(c)(12), insofar as [REDACTED] could be expected to be taxable in some years and exempt in others, and should this expectation have anything to do with the calculation of credits.

In a year that [REDACTED] is exempt, section 48(a)(4) limits its section 38 property to that used predominantly in an unrelated trade of business the income of which is subject to tax under section 511. Exemption in a particular year would likely preclude investment tax credits being available insofar as no [REDACTED] plant would likely be predominantly used for unrelated activities. With respect to the other portion of the issue raised, it is not the expectation that [REDACTED] will be exempt in some years, and not exempt in others that justifies the spreading of deductions and credits. Rather, it is how the sellback agreement is structured to allow [REDACTED] to take accelerated depreciation and investment tax credits as well as overstate transmission expenses that supports challenge of [REDACTED]'s allocation method as unreasonable.

With respect to Issues 1, 3, 4, 14, 15 and 20, the Special Trial Attorney should be furnished with copies of the materials mentioned herein if they are not readily available to him. If you have any questions on the above, or need any further assistance, please contact Ronald Weinstock (CC:TL:Br4) at FTS 566-3345.

Issue 21:

Treas. Reg § 1.61-5(a), which applies to [REDACTED]'s patrons because [REDACTED] is not a Subchapter T cooperative (Treas. Reg § 1.61-5(h)) states:

In general. Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section, regardless of whether the allocation is deemed, for the purpose of section 522, to be made at the close of preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way

dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

Thus, the Service's position is that the patron includes patronage dividends in income in the year received regardless of whether the patron uses the accrual method of accounting.

Issue 22:

A cooperative must treat all of its patrons equally. See Rev. Rul. 70-481, 1970-2 C.B. 170; Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. 674, 686 (1958); aff'd, 288 F.2d 326 (8th Cir. 1961). It cannot charge one patron less than another for the exact same product or service. Otherwise, the patron who paid less would have an unfair advantage over the other patrons and the patron who paid less would, in effect, be subsidized by the other patrons. On this point it should be remembered that a cooperative is, in effect, a nonprofit organization that operates at cost. Furthermore, a patron who received products or services at a cost less than that charged the other patrons could receive a patronage dividend (based on the amount of products or services purchased) greater than that to which he is entitled.

However, different products may have different costs. As long as the same product or service has the same cost for all patrons, the cooperative treats its patrons equally.


In the instant case, [REDACTED] charged its individual patrons for electricity based on the peak amount of electricity used by each individual patron. The more electricity a patron used, the less cost per kilowatt hours [REDACTED] charged. Assuming that there were underlying reasons for charging less per kilowatt for large users of electricity as opposed to smaller users, such as economies of scale, and assuming that [REDACTED] used the same sliding scale for all its patrons, then [REDACTED] treated its patrons equally.

Furthermore, the same rationale would apply to the price of electricity charged by [REDACTED]'s patrons to the ultimate consumers (i.e., residential, commercial or industrial users). [REDACTED]'s patrons charge their patron's for electricity based on a sliding scale similar to the one used by [REDACTED]. Larger users (industrial and commercial) pay less than small (residential) users. Assuming that it's because of the larger industrial or commercial users that [REDACTED]'s patrons pay less to [REDACTED] for a kilowatt of power, it would be equitable to pass this on to [REDACTED]'s patron's patrons.

If you have any questions concerning any of the issues discussed herein, please call Lawrence Mannix at FTS 566-3470.

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